JUNE 2022

AFG response to European Commission targeted consultation on the functioning of the ESG ratings market in the European Union and on the consideration of ESG factors in credit ratings

AFG

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The AFG federates the asset management industry for 60 years, serving investors and the economy. It is the collective voice of its members, the asset management companies, whether they are entrepreneurs or subsidiaries of banking or insurance groups, French or foreigners. In France, the asset management industry comprises 680 management companies, with €4355 billion under management and 85,000 jobs, including 26,000 jobs in management companies.

The AFG commits to the growth of the asset management industry, brings out solutions that benefit all players in its ecosystem and makes the industry shine and develop in France, Europe and beyond, in the interests of all. The AFG is fully invested to the future.

AFG RESPONSE TO EC CONSULTATION ON THE FUNCTIONNING OF THE ESG RATINGS MARKET AND ON THE CONSIDERATION OF ESG FACTORS IN CREDIT RATINGS

Part A – ESG Ratings

I. USE OF ESG RATINGS AND DYNAMICS OF THE MARKET

3. Questions for all respondents

Do you consider that the market of ESG ratings will continue to grow?

Yes.

If you responded "yes" to the previous question, to what extent do you expect the following factors to be decisive, on a scale from 1 (not at all) to 10 (very much)?

	1	2	3	4	5	6	7	8	9	10
Growth in demand from investors in ratings of companies for their investment decisions								X		
Growth in demand from companies in ratings including on rating future strategies								X		
Further standardisation of information disclosed by companies and other market participants										X
Other										X

If you responded "other" to the previous question, please specify the other reasons you see for this market to continue to grow

As SFDR/MIFID regulations come into force, ESG ratings and related information will grow in relevance as these regulations will serve to standardize and enhance existing financial institution and corporate disclosures on sustainability-related topics. As financial markets thrive on information, the availability of new and cleaner data from issuers will facilitate price discovery and could possibly mitigate systemic market risk. In this context, ESG providers' influence should grow.

Do you consider there is a sufficient offer of ESG ratings from providers located in the European Union?

No.

If you responded "no" to the previous question, please explain why

Provision of ESG data and ESG ratings in the EU depends on an oligopoly of – mainly non-EU data and rating providers. This situation places EU market participants in a weak and captive position for gathering the requested ESG data to comply with the EU regulation. The absence of EU authorisation and even localisation requirements for data and rating providers providing financial, non-financial data and ratings to European users is **concerning for the EU's sovereignty and safety, notably in relation to the European Commission' Strategy for financing the transition to a sustainable economy.** We believe that, as part of a future framework for data and rating providers, **the obligation for data providers to set up an EU-based legal entity to provide for services to EU clients would make sense and preserve EU competitiveness and sovereignty.**

Finally, do you use other types of ESG assessment tools than ESG ratings (e.g. controversy screening, rankings, qualitative assessments, etc.)?

Yes.

If you responded "yes" to the previous question, how important are these tools in relation to the implementation of your investment strategies and engagement policies?

French asset managers use a wide range of tools to implement their investment strategies and engagement policies: controversy screening, exclusion policies, qualitative assessment, ESG scoring, engagement with shareholders…

II. FUNCTIONING OF THE ESG RATINGS MARKET

How do you consider that the market of ESG ratings is functioning today?

Not well.

Please explain your answer

In the current state of the legislation, some challenges need to be addressed:

- **Non-financial information is not always available**: there is no or little constraint for companies to disclose such information.
- When data is available it is **not standardized.** Although we do not consider that methodologies of ESG Ratings should be the same, as a diversity of focus areas on ESG themes and methodologies is both a competitive factor and an enrichment of tools at the disposal of asset managers, we want to highlight the need for row data that is reliable and accessible to the general public.
- **Methodologies** on some ESG aspects **are still being developed** and are subject to changes.

- There is a **lack of harmonisation around key indicators** (e.g. scope 3 and avoiding double counting at the portfolio aggregation level) **and lack of transparency behind methodologies** for market participants.
- There is no public/free database where investors and public can access raw ESG data from issuers (raw: unbundled from analysis).

All these challenges make it difficult to have a comprehensive, reliable, and comparable framework on ESG data.

If asset managers recognise the value added of ESG data and rating providers, AFG strongly think they should be regulated, and become more transparent, as the use of their ratings faces lots of challenges.

They have developed **internal scoring methodologies that do not include the same factors on E, S and G pillar**. They measure, weight and score company sustainability risk and performance in different ways. This results in companies having different ratings depending on the ESG rating provider, often leading to orthogonal results. The dispersion in ESG ratings is very high, while the dispersion in credit ratings for a same issue/company is very low.

Moreover, **data and rating providers can also change methodologies from year to year** making historical comparisons difficult (is the variation of ESG rating due to the company progress, the change in methodology or both?). In this context, transparency is even more at stake, as it is essential for both issuers rated and users to fully understand the changes undertaken and their impacts on final rating.

The opacity behind methodologies makes it difficult to understand variation in ESG ratings.

It is also important to note that there is a **heterogeneous coverage of companies** with a satisfactory score for large capitalisations and companies from developed countries, but data is lacking in other areas. Cultural specificities also generate a bias depending on the provider nationality and ESG philosophy which does not help when dealing with raw data.

Finally, ESG data and rating providers have inherent conflicts of interest (particularly with providers both evaluating companies or portfolios and offering paid advisory services).

To what degree do you consider that the following shortcomings / problems exist in the ESG ratings market, on a scale of from 1 to 10 (1- very little, 10 – important)?

	1	2	3	4	5	6	7	8	9	10
Lack of transparency on the operations of the providers										X
Lack of transparency on the methodologies used by the providers										X
Lack of clear explanation of what individual ESG ratings measure										X

Lack of common definition of ESG ratings							X			
Variety of terminologies used for the same products							X			
Lack of comparability between the products offered						X				
Lack of reliability of the ratings						X				
Potential conflicts of interests								X		
Lack of supervision and enforcement over the functioning of this market										X
Other										X

If you responded 'other' to the previous question, please explain which ones

Opaque pricing and imposed commercial framework (contractual jurisdiction, reuse, bundled offers, ...).

What do you think of the quality of the ratings offered on a scale from 1 (very poor) to 10 (very good)?

3

Please explain why

As previously said, some challenges need to be addressed for the ESG rating market to function properly. The AFG has identified the following obstacles (for further detail please refer to our answer regarding our views on the functioning of the market of ESG ratings):

- **Non-financial information is not always available** and is not standardized.
- **Methodologies** on some ESG aspects **are still being developed** and are subject to changes.
- There is a **lack of harmonisation around key indicators** (e.g. scope 3 and avoiding double counting at the portfolio aggregation level) **and lack of transparency behind methodologies** for market participants.

These obstacles also have an impact on the quality of ratings, quality being heterogenous depending on the provider and the methodology used.

If you responded 'very poor' or 'poor' to the previous question, wo what degree do you consider that this affect your trust in the products that are offered, on a scale from 1 (no affect) to 10 (affects very much)?

8 – this leads to the use of multiple data providers and the need to develop tools/approaches in order to get a better view on the issuer's quality or to make data mining before using the ESG factors to inform investment decisions.

Do you consider that there are any significant biases with the methodology used by the providers?

Yes.

If you responded yes to the previous question, please specify the biases

- Biases based on the size of the company rated
- Biases based on the location of the company
- Other biases
- Don't know / no opinion / not applicable

Biases ;

- Based on the size of the company rated
- Based on the location of the provider
- Due to the nature of the corporate itself: listed vs unlisted corporates, sectors, legal status, etc.
- Due to the treatment of the raw data sourcing the rating : availability, collection process,...

Do you think the current level of correlation between ratings assessing the same sustainability aspects is adequate?

No.

As previously said, ESG rating methodologies are not always transparent, which is not in the interest of issuers rated and users.

It is also important to note that there is a **heterogeneous coverage of companies** with a satisfactory score for large capitalisations and companies from developed countries, but data is lacking in other areas. Cultural specificities also generate a bias depending on the provider nationality and ESG philosophy which does not help when dealing with raw data.

These bias and the variation that occurs across methodologies contribute to weak correlation (and high divergence) across scores from different rating companies.

To what degree do you consider that a low level of correlation between various types of ESG ratings can cause problems for your business and investment decision, as an investor or a rated company, on a scale from 1 (no problem) to 10 (significant problem)?

6

The fact that an ESG rating differs from another on a same issuer is not per say problematic if it can be explained by different methodologies and if it is well documented. Nevertheless, there is an issue with the reliability and the fact that some common ground /standards are needed at the company data level to ensure the ratings reflects the analysis of reliable data related to materiality and correct assessment of ESG factors. Finally, a wide dispersion between ESG rating providers can reduce the readability of ESG ratings.

How much do you consider each of the following to be an issue, on a scale from 1 (no issue) to 10 (very significant issue)

	1	2	3	4	5	6	7	8	9	10
There is a lack of transparency on the methodology and objectives of the respective ratings										X
The providers do not communicate and disclose the relevant underlying information										X
The providers use very different methodologies					X					
ESG ratings have different objectives (they assess different sustainability aspects)					X					
Other										X

If you responded 'other issue' in the previous question, please explain which one(s)

- ESG data and ratings in the EU depends on an oligopoly of mainly non-EU data and rating providers.
- When a client imposes a provider which requires a change of the existing provider for a given fund, it is difficult to keep a history as methodologies change across providers.
- ESG providers have great market power and can unilaterally set contractual conditions, based on their jurisdiction, due to the current dependency of users on them.
- ESG providers have opaque pricing and licensing frameworks.

Do you consider that a variety of types of ESG ratings (assessing different sustainability aspects) is a positive or negative feature of the market?

- Rather positive
- Rather negative
- Don't know/no opinion/not applicable

Rather positive if objectives and methodologies are clearly explained, transparent and without any risk of confusion.

Standards or rules should not undermine the current diversity of methodologies/focuses offered by ESG rating providers which is crucial for investors to inform their decision on which ESG data provider(s) to choose, and to which extent they will use such data in their proprietary scoring. Competitiveness should be maintained, and stricter rules should not result in further concentration of these providers and reduced diversity.

Other reasons we are having multiple providers include complementarity of the data, and the possibility to benchmark and compare different methodologies in the absence of global standards for the industry.

To what degree do you consider this market to be prone to potential conflicts of interests on a scale from 1 (very little) to 10 (very much)?

8

Conflicts of interest can arise for instance when data providers are both evaluating companies and offering the same companies paid advisory services. Nevertheless, the risk of conflicts of interest seems lower than on the credit rating markets, considering issuers are not paying for their overall ESG ratings. As mentioned previously, we believe that transparency on many aspects including the handling of conflicts of interests should be enhanced. That could be through the adoption of common good practices standards

If you responded 'yes' to the previous question, where do you see the main risks? (multiple choice)

- Where providers both assess companies and offer paid advisory services
- Where providers charge companies to see their own reports
- In the absence of separation of sales and analytical teams
- With the ownership system of some providers, where the parent company may exert undue pressure or influence on the research and recommendations that a ratings provider offers
- In the lack of public disclosure of the management of potential conflicts of interest
- Other conflict(s) of interest

If you responded ‘other(s) conflicts of interest’ to the previous question, please specify the additional risks you see

To what degree do you consider that the ESG ratings market as it operates today allows for smaller providers to enter the market on a scale from 1 to 10 (1- hard to enter, 10 – easy to enter)?

5

Not so difficult for small providers to enter the market today but they will have funding issues and difficulties to gain market share over time due to a lack of capital to finance their business development: among the small providers only the niche ones would eventually survive. The issue is more linked to the inability for a small player to cover the whole market as well as to the user’s regulatory constraints and not to the regulation on providers themselves.

What barriers do you see for smaller providers?

The absence of standards inflated the number of needed experts/analysts, the need for economies of scale, problem of large coverage. Most of the new small providers that have developed new interesting assessment approach are start-ups that have been bought by the main international actors.

Do you consider that the market currently allows for smaller providers who are already present in this market to remain competitive on a scale from 1 (does not allow) to 10 (fully allows)?

5

In the short term, niche players can exist but, it is uncertain on the long run. This said, their capacity to innovate, their flexibility and responsiveness can be an advantage. Still, the transparency of methodologies should be standardised.

To what degree do you consider the fees charged for ESG ratings to be proportionate to the services provided, on a scale from 1 (not proportionate) to 10 (very proportionate)?

4

- Fees are function of the type of ESG product provided and of the scope coverage. Package fees are also common, more favourable to big asset managers.
- Fees are too expensive and the annual fee inflation that could be around 7/8% the past years.
- Fees are complex: no transparency on fee pricing model.

– Small players have more fee negotiation flexibility: more balanced/favourable negotiating power for asset managers as users

Do you consider that information on the fees charged by the providers is sufficiently transparent and clear?

No.

Do you consider that information on the fees charged by the providers is sufficiently transparent and clear?

Information on the fees charged by providers is not transparent enough. This is even more important when we know that data fees can impact the pricing of a financial product and have an impact on the end investors.

Transparency is then required and could draw on the fair, reasonable, non-discriminatory and transparent principle (FRANDT) already existing in the EMIR Regulation.

III. EU INTERVENTION

a. Need for an EU intervention

Taking into account your responses to the previous sections, do you consider that there is a need for an intervention at EU level to remedy the issues identified on the ESG rating market?

Yes.

Please explain why

We have identified some challenges that need to be addressed and that would require an EU intervention : lack of transparency on methodologies and indicators for example (please refer to our previous answer on the functioning of ESG ratings markets for further detail).

An EU intervention is required to tackle different risks arising from the current ESG rating market situation:

- Perception of a **"greenwashing" risk**.
- **Arbitrage due to ESG ratings variation among data providers**.
- **Misleading investors** due to fragmented data availability, lack of transparency with regards methodologies and a lack of contextualized information. Indeed, a company could be rewarded only because its coverage rate is higher or because the company discloses more ESG information, even if its ESG practices are weak.

- **Conflicts of interest**: when data providers are both evaluating companies and offering paid advisory services.

We would like to insist on the scope of the EU intervention. In the ESG space, It should not be limited to ESG ratings but also cover ESG "non-financial" data as described above.

If you responded yes to the previous question, what type of intervention would you consider necessary?

- Non-regulatory intervention (e.g. guidelines, code of conduct)
- Legislative intervention
- Don't know/ no opinion / not applicable

We believe that the EU should create a holistic regulatory framework for data and rating providers (for both financial and non-financial information).

Finally, the EU regime should also require for non-EU data and rating providers to set up EU legal entities when willing to provide services to EU clients. Otherwise, the provision of services by non-EU based providers. The current absence of EU authorisation and even localisation requirements for data providers providing financial and non-financial data to European users is **concerning for the EU's sovereignty, notably in relation to the European Commission' Strategy for financing the transition to a sustainable economy**. We believe that, as part of a future framework for data providers, **the introduction of the requirement for non-EU providers to set up an EU-based legal entity to provide services to EU clients would make sense and preserve EU sovereignty and legal safety.**

If you responded yes to the previous question, what do you consider should be the prime focus of the intervention? (multiple choice)

- Improving transparency on the operations of the providers,
- Improving transparency on the methodology used by the providers,
- Improving the reliability and comparability of ratings,
- Clarifying what is meant by and captured by ESG ratings, to differentiate from other tools and services,
- Clarifying objectives of different types of ESG ratings,
- Improving transparency on the fees charged by the providers,
- Avoiding potential conflicts of interests,
- Providing some supervision on the operations of these providers,
- Other measures (please specify).

For each of the points you selected in the previous question, please explain what solutions and options you would consider appropriate

We believe that the reliability of ESG ratings tends to improve in the coming years due to:

- The **implementation of the CSRD** whose objective is to address problems in the comparability, consistency and relevance of sustainability information disclosed by companies. The CSRD will harmonize non-financial reporting and will require an audit of the information, ESG data will then be comparable and reliable.
- The **upcoming ESAP** for EU financial and non-financial data that will allow an access to reliable, comparable, and audited non-financial data.

These new regulations will be beneficial for competition within the EU, as data and rating providers will have to clearly demonstrate their added value and commercial proposals compared to in-house analysis. This will increase the overall quality and transparency of these markets.

Yet, we believe, as explained in our previous answer, that further steps should be implemented to address the identified challenges. T**he EU should create a holistic regulatory framework for data and rating providers (for both financial and non-financial information).**

This framework **should focus on increasing data and rating providers'**:

- **Transparency on the methodologies used as well as how data is obtained and verified**: the fact that an ESG rating differs from another on a same issuer is not per say problematic if it can be explained by different methodologies.
    - The provider should have robust operational and control process in place to ensure a continuous service and provide sufficient detailed information on such processes
    - ESG ratings and data providers must be required to disclose the sources of their data, their data collection processes, how missing data are dealt with and the methodology for estimation, and their data quality controls, among other things. Transparency in case of changes to the methodologies should also be provided.
- **Transparency regarding data fees**: requirements on the matter could draw on the fair, reasonable, non-discriminatory and transparent principle already existing in the EMIR Regulation.
- **Accountability requirements tackling notably conflict of interests and market abuses**: code of conduct and best practices.
    - ESG data providers must be required to detail their governance and internal controls, their compliance practices for managing conflicts of interest.
    - ESG data providers shall disclose such policy on their website.
- **Dialogue with rated companies**
- **ESG data should face the same level of requirements as financial data and should be audited by a third-party.**

If you responded 'other' to the previous question, please specify the other elements the intervention should focus on

Do you consider that the providers should be subject to an authorisation or registration system in order to offer their services in the EU?

Yes.

Please explain why

As previously said, we believe that the obligation for f non-EU data and rating providers to set up an EU-based legal entity to provide services to EU clients should be implemented as provision of ESG data in the EU depends on mainly non-EU data and rating providers. This situation places EU market participants in a weak and captive position for gathering the requested ESG data and ratings to comply with the EU regulation. The absence of EU authorisation and even localisation requirements for data and rating providers providing financial and non-financial data to European users is **concerning for the EU's sovereignty and safety, notably in relation to the European Commission' Strategy for financing the transition to a sustainable economy**. We believe that, as part of a future framework for data providers, **the introduction of an obligation for for third-countries data providers to set up EU-based legal entities to provide services to EU clients should be ensured and preserve EU sovereignty and safety.**

Do you consider that the providers should be subject to an authorisation or registration system in order to provide ESG ratings on EU companies or non-EU companies' financial instruments listed in the EU even if they offer services to global or non-EU investors?

Yes

Please explain why

In order to ensure a fair competition, the same conditions should apply for EU and non-EU providers.

Do you consider that there should be some minimum disclosure requirements in relation to methodologies used by ESG rating providers?

Yes.

Please explain why

Minimum disclosure on the methodology used will allow investors to understand the ESG rating provided and improve comparability between ESG rating providers. Such minimum disclosure should not be prescriptive in terms of methodology but should be focused on transparency and good practices of the industry.

Do you consider that the providers should be using standardised templates for disclosing information on their methodology?

Yes.

Please explain

A standardized template will facilitate comparison between ESG rating providers. It should be reminded that a standardized template should not lead to standardize methodologies.

Should the providers located outside of the EU, not providing services to the EU investors but providing ratings of the European companies/financial products be subject to a lighter regime?

Yes/No/No opinion.

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